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by: John H. Ford

MGT Capital Investments (NYSEMKT:MGT) just announced that it is suing the following five companies for patent infringement: MGM Resorts International (NYSE:MGM), Caesar's Entertainment Corporation (NASDAQ:CZR), Penn National Gaming (NASDAQ:PENN), WMS Industries (NYSE:WMS-OLD), and Aruze Gaming.

According to a MGT investor presentation, this case could generate between \$330 million and \$4.5 billion over the life of the patent (10 years). MGT currently has a very low market cap of \$59 million primarily because Wall Street just isn't aware of this company yet, as there is no analyst coverage. This is the type of undervaluation and leverage I look for, where a \$59 million company could receive up to \$4.5 billion in royalties.

The patent involved in this lawsuit is US Patent No: 7,892,088 titled: *Gaming Device Having a Second Separate Bonusing Event*, and was issued in February of 2011. Casinos and slot machine manufacturers are allegedly infringing upon this patent with their group play slot machines.

This new breed of slot machines allows players to compete against the house as well as other players during special bonus rounds. This creates multiple levels of excitement and new ways to generate big wins. In short, group play slot machines are just a lot more fun than the old-style machines.

Casino patrons love group play slot machines

When I recently visited a casino, the group play slot machines were the most popular gaming devices on the floor. Here's how they work:

Each player is playing on his/her own slot machine, but at random times there will be a bonus event in which all players take part. The event is displayed on a large LCD screen on top of a group of slot machines. All players taking part in the bonus event will share in the jackpot. The amount won by the individual player is based on the amount he/she is betting per spin.

If you want to see what the excitement is all about, watch this video which features Paradise Fishing, an allegedly infringing game. For a detailed explanation of Paradise Fishing, click [here](#).



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Another popular and allegedly infringing machine is called Pirate Battle. Click here to watch a video. Other machines named in the suit are Reel'em In Compete to Win, Great and Powerful Oz, Battleship and Clue.

I suspect there are additional games, manufacturers, and casinos that could be infringing, and an announcement of more lawsuits would be good for MGT's share price.

Market size

People love to gamble. Global casino gaming revenue was \$132 billion in 2011 and is expected to grow to over \$146 billion in 2012. Slot machines are the most popular gambling method in casinos and generate about 70% of the average US casinos' income.

As noted in a recent study, there are 4,205,608 slot machines worldwide, and over 800,000 in the United States. Group play slot machines are relatively new, and according to MGT there are currently up to 10,000 allegedly infringing machines. But since these games are so popular, they could begin to displace single player slot machines at a fairly rapid clip.

If group play slot machines were able to capture 25% of the United States slot machine market, that would equal over 200,000 machines. Even if MGT were only able to receive royalties for 20,000 machines, that could still provide the company with hundreds of millions of dollars in annual revenue.

Right now, the allegedly infringing machines are only addressing 1.25% of the United States slot machine market which gives MGT tremendous upside potential.

MGT's potential settlement numbers

MGT estimates that each group play slot machine generates about \$4000 per day in revenue for the casinos, or \$1.46 million annually. With 10,000 allegedly infringing machines, the annual revenue for casinos is \$14.6 billion

If the defendants were to pay MGT a 1% royalty, MGT could receive \$146 million annually, or \$1.46 billion over the 10 year life of the patent (before taxes and legal fees).

If MGT receives a 2.5% royalty, MGT's annual revenue would be \$365 million, or over a 10 year period \$3.65 billion.

My calculations are based on 10,000 allegedly infringing machines, but since I believe this number will grow, the revenue potential for MGT could be substantially higher.

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MGT is asking for a reasonable royalty rate

Just to put things in perspective, in a study of 2279 licenses in 15 industries, it was shown that the median royalty in most industries is about 5% of gross sales. If the average is 5%, and MGT is asking for between 1% and 2.5%, in my opinion, MGT's law firm is litigating this case very conservatively by asking for royalty rates well below the average.

If you want to look at royalty rates for patent infringement cases similar to MGT's, the best example involves Triple Play Poker invented by Ernie Moody in the late 1990s. In this suit, Action Gaming and International Gaming Technology sued Bally Gaming and United Coin for patent infringement. This lawsuit set the bar for the industry which in this case was set between 15% and 20% of gross profits, which roughly equals 1.5% to 2% of gross sales.

MGT's legal team

MGT has teamed up with Nixon & Vanderhye, a tier 1 patent litigation law firm. (Nixon & Vanderhye was named by US News among the best law firms in America for 2011 and 2012.) In my opinion, this law firm is ideal because of its experience in the gaming industry.

In a case Nixon & Vanderhye litigated against Progressive Games for Prime Table Games, the jury found that Prime had been damaged by Progressive's attempt to use those patents to monopolize the relevant proprietary casino table game market. Prime had lost \$13 million in profits, which it would otherwise have earned. This verdict, which was then trebled to \$39 million under the antitrust laws, was sustained by the trial judge who also awarded Prime its attorneys fees and costs.

Robert Rowan, a senior patent litigator and past Director of Nixon & Vanderhye stated, "With more than 35 years of experience in intellectual property litigation, I am very excited to work with MGT on this matter. Based on my professional experience in hundreds of complex intellectual property and business litigations, I am optimistic of successfully and expeditiously enforcing MGT's patent rights in its linked interactive screen enhancement to the slot machine gaming experience."

This patent should be easy for a jury to understand

One of the things I like about this case is that the patent is relatively easy to understand. Here's a synopsis: *At least two slot machines are linked together, and then players compete against each other and the house during a bonus round which is displayed on a giant LCD screen.* For a visual representation and a more in-depth look at the patent, click [here](#).

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Here is the entire patent claim:

"A gaming machine system comprising: at least two gaming machines linked together, said gaming machines linked to an interactive sign; said at least two gaming machines allowing at least two players playing a first regular game on said at least two gaming machines; a device connected to said gaming machines to direct said at least two players to play a second bonusing game after satisfying a certain operation of the linked gaming machines that triggers a bonusing event from said linked machines; said second bonusing game is a bonusing video game to be played on said interactive sign; said interactive sign comprising an LCD screen; said LCD screen displaying said bonusing video game that players enter in once said bonusing trigger event occurs on the said at least two linked gaming machines; wherein said LCD interactive sign allowing said at least two players playing said at least two linked gaming machines enter said bonusing game and compete against each other by playing said bonusing video game on said LCD interactive sign."

This patent appears to cover all the bases, and from my perspective, seems to describe what group play slot machines do. If the case ever comes before a jury, in my opinion, MGT's attorneys should be able to show the correlation between group play slot machines and MGT's patent. This is something that the most unsophisticated jury member could understand. This by no means guarantees that the jury will side with MGT, but at least MGT's law firm should be able to present a compelling case.

Prior art should not be an issue

The concept of this patent is so simple that if there were any prior art, it should have been very easy to find. Either the United States Patent Office or MGT's attorneys should have discovered any prior art. This is not like a software patent which carries such a high level of complexity that prior art could be buried somewhere or completely misunderstood.

My field trip to a casino

Since I had never seen group play slot machines in action, I decided to take a trip to a casino and see what the excitement was all about. Before going, I called some casinos to find out just how popular these machines were, and was told that if I were to come during the peak hours, I would probably have to wait just to get a seat.

With that in mind, I showed up on a Tuesday morning at 10:30 AM, when the casino was about 20% full. The first group play slot machine I was able to locate was Wheel of Fortune, which turned out to be a very popular game with most of the seats already taken.

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This game had the largest LCD display that I had ever seen. It looked like it was at least 8 feet wide and displayed impressive HD graphics. The whole time I was in the casino, numerous customers were playing this game rather than the old-style single player slot machines which didn't seem to be as popular.

I walked around until I found another group play slot machine, Paradise Fishing. This game was not as crowded, with only about half the seats taken. I decided to give it a try.

It was definitely more fun than the old-style slot machines. With two ways of earning money, first with the slot machine and then with the bonus rounds on the giant LCD display, I just kept feeding the machine money. This was not a profitable endeavor, but it was entertaining.

I then wandered around the casino and was surprised to see that slot machines in general, took up about 75% of the casino's floor space. These games are more popular than I realized, and probably generate more revenue per square foot than any other casino game. On a per machine basis, they take up a very small amount of floor space, don't require an employee to run them, and need very little maintenance. Slot machines emulate an ideal business model.

The group play slot machines, given their high level of entertainment value, take this business model to the next level. Just from my observations, on a per machine basis, group play slot machines appeared to be taking in significantly more money than the old-style machines. If I had a high-traffic location where I could legally install some machines, I would buy a few and put myself in business.

To sum things up, I do like group play slot machines better than the old-style slot machines, primarily because you have two chances of winning. For that reason, I believe group play slot machines will ultimately take over the slot machine market, and if MGT can successfully prosecute these cases, the company's upside potential becomes extreme.

Why I think MGT is worth \$18 a share today

MGT believes the royalty potential for these cases is between \$330 million in \$4.5 billion, giving us a median recovery of \$2.41 billion. In order to keep my estimates on the conservative side, I will use \$1 billion as a potential recovery figure.

MGT currently has \$6.5 million in cash, no debt, and only about 8.4 million fully diluted shares. If all the warrants were exercised, the total cash would be \$21 million.

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With the current \$7 share price, this gives MGT a \$59 million valuation. If we back out the \$21 million in cash (warrant exercise included), the market is giving MGT an enterprise value of \$38 million.

With a \$1 billion potential recovery and an enterprise value of \$38 million, MGT has an extremely low valuation to recovery ratio (V/R) of 3.8. In other words, MGT's current enterprise value represents only 3.8% of the potential \$1 billion recovery, which in my opinion is way too low.

Compare that to VirnetX (NYSEMKT:VHC), which had about a \$100 million pretrial valuation before winning \$200 million from Microsoft. The pretrial valuation represented about 50% of VirnetX's potential recovery, giving VirnetX a V/R ratio of 50. Remember, at that time VirnetX had a completely unproven patent portfolio, just as MGT has now, but VirnetX's V/R was 13 times higher than MGT's.

So here sits MGT, undiscovered by Wall Street, with an enterprise value equal to 3.8% of the potential recovery. If MGT's valuation climbs to a more reasonable, but still low 15% of the potential \$1 billion recovery, MGT's share price would be \$18. This share price appreciation could happen imminently. As we get closer to the trial, or if there are any positive catalysts, MGT's V/R ratio could reach 50% or higher, as was the case with VirnetX and other IP companies, giving MGT a valuation of \$500 million and a share price of \$59.

Why shares could soar tenfold or more: an EPS analysis

Ultimately, a one-time payment may be made, but an EPS valuation over the ten-year patent life does provide a good perspective on potential share price appreciation. I have not discounted the future value of the royalty payments because I believe the group play slot machine growth rate, which I've also not included, will more than balance that out.

Based on MGT's estimated present value of royalties over the life of the patent, here are three potential settlement outcomes and the corresponding share prices:

\$330 million total settlement: \$33 million annual royalty payments, reduced to \$16.5 million after taxes, legal fees and other expenses, gives us an EPS of \$1.96 or with a PE of 15, \$29 per share.

\$2.4 billion total settlement: \$240 million annual royalty payments, reduced to \$120 million after taxes, legal fees and other expenses gives us an EPS of \$14.2, or with a PE of 15, \$213 a share.

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\$4.5 billion total settlement: \$450 million annual royalty payments reduced to \$225 million after taxes, legal fees, and other expenses, gives us an EPS of \$26.7 or with a PE of 15, \$401 per share.

What makes these EPS numbers so high is the extremely low share count and market cap, relative to a very high potential recovery. Most other IP companies have share counts of at least 50 million, and very few of them are addressing \$4.5 billion potential settlements.

MGT is seeking treble damages

All of my calculations have intentionally left out an important component, which is the fact that MGT stated in its recent press release that it is seeking treble damages. What's significant here is not so much whether or not MGT will actually get treble damages, but that this could make the defendants more willing to settle. Treble damages implies willful infringement, and in my opinion, if one or more of the defendants are willfully infringing, they could be more willing to settle.

CEO has invested his own money in MGT

This is something we rarely see anymore, but Robert Ladd, MGT's CEO has invested \$2 million of his own money in this company. This is the kind of commitment I like to see from management, and in my opinion, is a good indication of the company's strength and potential.

MGT has an extremely low float

With a float of 1.25 million shares, the slightest bit of positive news could send the share price soaring. We saw that last week when the share price more than doubled, just as a result of the company announcing a successful capital raise. There just aren't a lot of tradable shares out there, and it will be fairly easy to reach an imbalance consisting of too many buyers and not enough sellers. If that happens, we could see extremely aggressive share price appreciation.

Gaming industry replacement cycle could provide another catalyst for MGT

Casinos replace their gaming devices about every seven years, and the last replacement cycle began in 2001. If you had bought Bally Technologies (NYSE:BYI), or International Game Technology (NYSE:IGT) in 2000, you could have quadrupled your money in a couple of years as gaming companies benefited from the replacement cycle.

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The next replacement cycle should have begun in 2008, but we were hit with the recession, and casinos put their investments on hold. It appears that casinos have not yet begun the now delayed replacement cycle, so when the next cycle begins, it should hit with a vengeance. When I visited a casino, I saw a lot of very old-looking machines, with the exception of the group play devices.

Once the economy turns around, casino spending could increase dramatically, which could benefit MGT.

Risks for investors:

The biggest risk for MGT shareholders, is that the case goes to court, and the jury rules against MGT. With any jury trial, the results are unpredictable. We don't know what kind of a case the defendants will present. On the plus side, I believe MGT has a good case, and a highly qualified legal team. 95% of all cases settle before trial, and with the 5% that do go to trial, most juries favor the plaintiff.

Another risk is that MGT is basing its entire business on one patent. However, if this patent is strong enough to generate a large settlement, it's definitely a moot point. With patents, quality always trumps over quantity, and one good patent can be worth more than 1000 mediocre patents. Also, MGT has stated that it intends to acquire new IP, so this risk should be minimized in the future.

Conclusion

Once Wall Street realizes MGT is an undervalued, well-funded company with solid IP shooting at a \$4.5 billion potential recovery, the share price should at least double.

The Markman ruling should take place within nine months, and if MGT prevails on this front, the share price could approach the standard that we've seen with other IP companies, where MGT's valuation equals 50% of the potential recovery.

I believe MGT has a good chance of generating royalties either through a pretrial settlement, or a jury trial. The patent looks strong, and the correlation between the claim and what the group play slot machines actually do, seems obvious to me. For these reasons, I have initiated a long position.

For complete disclosure and disclaimer information please click [here](#)

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Disclosure: I am long MGT. I wrote this article myself, and it expresses my own opinions.

I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Additional disclosure: I am long VHC

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